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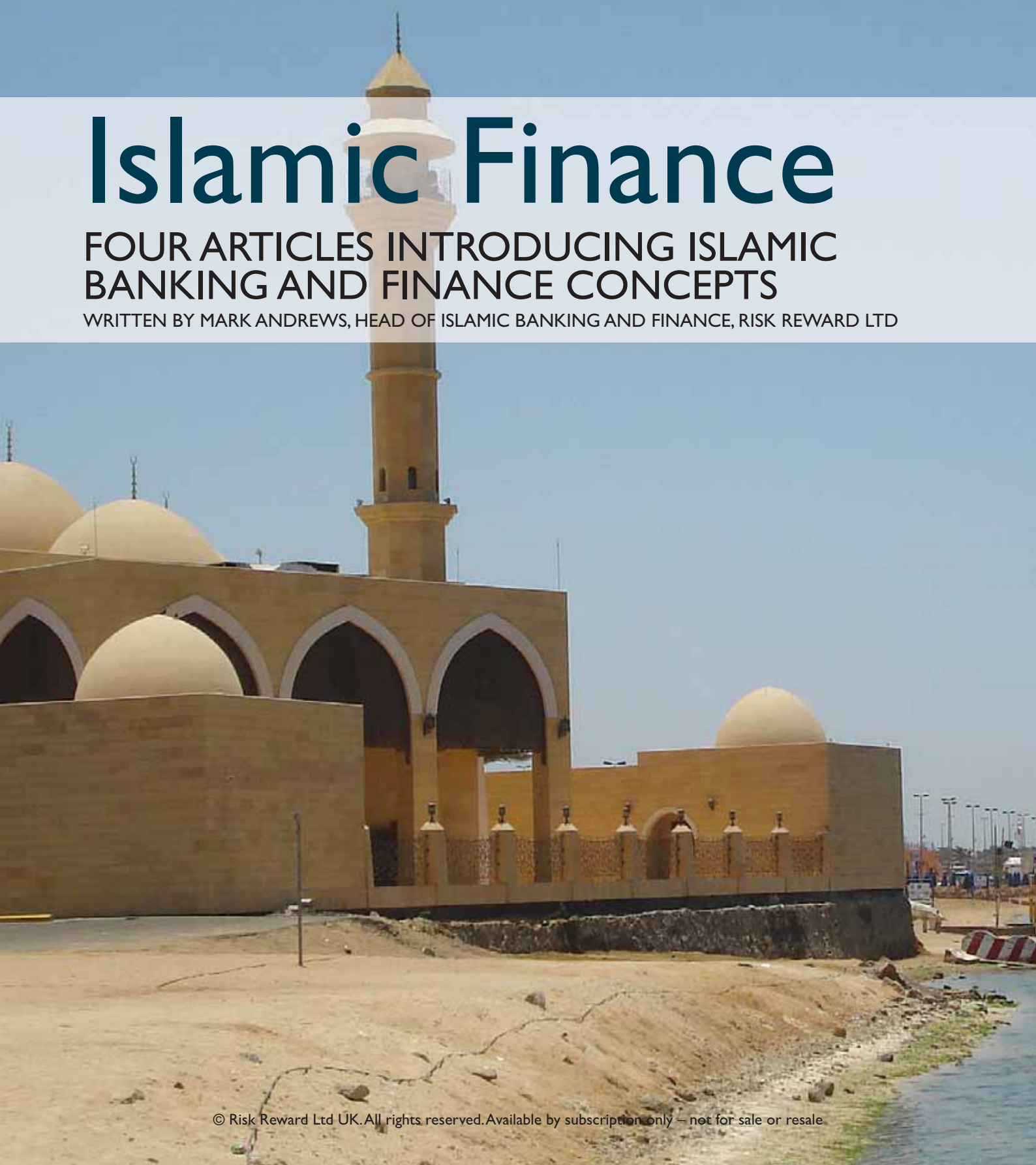
The quarterly independent risk review for banks and financial institutions worldwide

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## Islamic Finance

FOUR ARTICLES INTRODUCING ISLAMIC  
BANKING AND FINANCE CONCEPTS

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# ISLAMIC FINANCE

## AN INTRODUCTION

*This is the first of three articles introducing Islamic Banking and Finance concepts written by Mark Andrews, Head of Islamic Banking and Finance, Risk Reward Ltd.*

There is much to both admire and praise about Islamic Finance. Its stated ethos and principles are probably as close to a model for truly ethical and moral banking that has yet been developed and actually implemented on a large scale.

Based on the Quran, Islamic Finance offers its clients Shari'ah compliant banking but the real meaning and to be fair, the true benefits of this, are often lost on Western observers, some of whom have tended to dismiss the sector as yet another example of fundamentalist religious doctrine applied to real life. But this cynical view is not only undeserved it is also mostly inaccurate. In reality, even a cursory study of Islamic Finance and its guiding principles will confirm it is indeed probably the most successful model for ethical banking to date. But it is not without its weaknesses, not least of which is whether any institution can actually achieve the blueprint and live up to its full potential. The answer is almost certainly "no" but does this detract from its merits?

The whole concept of Shari'ah compliant banking is by Western terms still very much in its infancy. Some conventional banks have been trading for more than 400 years, most for at least 50 and it is often a surprise to many observers that modern Islamic Finance actually started in its present format as recently as 1985. Of course trading and commerce in the Islamic world is actually thousands of years old and pre-dates not only banking but Islam itself. The remarkable legacy of this ancient history is that the basic trading contracts have been refined over millennia and still survive, still work (in the main) and still underpin Islamic Finance.

The guiding principle of Islamic Finance is to provide banking and financial services which are compliant with Shari'ah. Shari'ah is the Divine Law as revealed in the Quran (Book of Allah SWT) and Sunnah (words or acts) of His Prophet Muhammad (PBUH).

The primary authority for Shari'ah is the Quran which means "the text of God" and is actually a blueprint for running a society with detailed rules covering every aspect of a Muslim's life including religious, family, community and of course trading obligations. It stresses fairness, honesty, integrity and morality to all, even towards non-believers, which comes as a surprise to some people.

Next is the Sunnah which means 'well known path'. It covers the words, acts and tacit approvals of the Prophet (PBUH) as recorded at the time and subsequently and includes the Sayings (Hadith) which He used to lay down the law and give moral guidance.

Next comes Ijma or "consensus/agreement" under which suitably qualified Islamic Scholars or Jurists are asked to rule on points of Shari'ah law where the answer is not immediately available from the two senior sources. Then follows Qiyas or

"analogy", which extends the law by applying common underlying attributes. Finally there is Ijtihad or "interpretation", where Islamic Scholars are asked to rule on an apparently unique problem.

This structure seems to be comprehensive enough until you are reminded that the primary sources, the Quran and the Sunnah, are actually 1,400 years old and chronicle the moral, commercial and religious challenges of that time. Even though the Prophet (PBUH) was clearly a pragmatist and may well have accommodated some of the modern structural differences, it is obviously a matter of faith that the historical texts are doctrine and must be applied literally and strictly.

Having to apply ancient standards to modern banking is and has been a real challenge. Critics say it is disingenuous involving replication and retrospective "shoe horning" to make it fit, but this dismissive swipe cheapens unreasonably the value of what has been achieved in a very short time. If you study the subject in detail it is hard not to congratulate most scholars for reaching remarkably successful compromises even where the challenge seemed incapable of being resolved.

Underpinning Islamic Finance are several basic rules which cannot all be listed in detail in this article but the main ones are:

- No uncertainty
- Trade must be in real goods and assets
- Sellers must be honest, totally frank and actually own what they sell
- There can be no speculation or gambling
- No trade in activities or products considered Haram or un-Islamic

These prohibited activities are generally well known and include no trade in pork, alcohol, armaments, pornography, etc.

The most significant basic rule and the one that perhaps most defines the ethos of Islamic Finance, is that all commerce must involve the real sharing of both profits and losses so that all parties, including the bank, have a real and tangible stake in the outcome of the transaction being undertaken.

Consequently, and unlike a conventional bank which does, an Islamic Bank does not have a debtor or creditor relationship with its depositors and customers.

With one exception (Amanah or Trust accounts which are safe custody deposits and are not usually significant in numbers or amount) "depositors" are actually investors, all of whom agree to invest alongside or via the Islamic bank and whose return is based on a share of the bank's actual profit and losses.

Investors place money in the Islamic bank as trading partners and are given a profit (and loss!) sharing share based on the





term,  
purpose, maturity, etc  
of the investment.

The actual investor accounts are based on the ancient contracts of Amanah, Wikala, Wadia, Mudaraba and Musharaka but are generally also reported as current accounts, investment accounts and special investment accounts by many Islamic Banks.

The key difference between Islamic “investors” and the “depositors” in a conventional bank is that Islamic investors agree to share profits and losses whereas conventional depositors do not, especially the loss part! In theory, therefore, a loss making Islamic Bank could and should pass on these losses to its investors who would see their investments reduced as a consequence.

So far, this has not been put to the test in a major way and it is debatable whether an Islamic Bank could actually pass on losses on a large scale, given that in reality most investors regard their stakes as a one way bet. Would it trigger a Northern Rock exodus? Possibly.

There are many myths about Islamic Finance principally that it is banking for Muslims only. This is not true at all. Anyone can open an investment account and apply for the full range of services on offer. Non-Muslims are welcomed.

The biggest challenge facing the sector is liquidity but not in quite the same sense that we use when looking at conventional banks. In a conventional bank liquidity is needed to repay depositors and liquidity “difficulties” usually means the bank cannot meet their withdrawal requests. It is fear that drives this process and usually triggers panic, which in turn starts a wholesale stampede as depositors jostle to get their money out first. Restoring confidence, very quickly, is the only solution, something the authorities failed to do with Northern Rock.

Faced with bank collapses in the West, all Islamic jurisdictions made it clear in unequivocal terms that they stood fully behind the Islamic banks in their territories. As these territories included some of the richest countries in the world, most Islamic investors are now satisfied that the risk of losing their money is minimal. Anecdotal evidence from various institutions suggests investors having seen the worst are now relaxed and no major withdrawals have been reported.

The liquidity challenge in Islamic banks is actually a treasury and profitability problem. There is no effective Islamic inter-bank market and banks cannot lend to or borrow from each other in conventional terms. As a result a bank that finds itself with too many investments or is short of cash, has limited options. The issues posed by this are beyond the scope of this article but typically surplus funds have to be held in low or nil yielding cash form and shortfalls are met by seeking discreet deposits from sovereign departments on a “lender of last resort” basis. This “super tanker” approach to liquidity management will be a real constraint on future growth.

### **Islamic Finance: Part 2**

In the next quarterly Risk Update we consider Riba or the banning of interest and the asset side of an Islamic Bank, including Musharaka which should be the star of Islamic banking but sadly is not.

# ISLAMIC FINANCE

## AN INTRODUCTION – PART TWO

*In the first article in this series Mark Andrews, Head of Islamic Banking and Finance, Risk Reward Ltd, covered the basic principles of Islamic Banking and described the funding sources of an Islamic Bank - or where it gets its money from. In this article, he will begin to consider the other side of the balance sheet, the asset side - or what an Islamic Bank does with its money. To do so, he challenges the reader to first deal with the issue of "Riba" because it is crucial to both understanding and accepting the basis on which a modern Islamic Bank trades.*

### Understanding the Concept of Riba

In over simplistic terms "Riba" means "interest" and Islamic Banks may neither charge nor pay interest on their funds. Its prohibition is contentious in some quarters, especially amongst non-Islamic institutions, but the fact remains that there is unanimous support amongst all Islamic Scholars for a total ban.

This ban or prohibition is often reported in critical terms by outsiders, which is ironic given that most developed economies have banned interest to some degree or other during their histories. However a total and not just partial ban seems both draconian and anachronistic at first sight.

There is also an unhelpful "elephant in the room" which makes understanding more challenging. It is quite a big elephant actually and is normally described thus: "If it is correct that Islamic Scholars have banned the charging or paying of interest of any kind and for any reason, why is it that all Islamic bank accounts, deposits, savings plans, loans, bonds, leases, credit cards, in fact almost every Islamic product, are linked in practice to one kind of interest rate or another? This is surely either a fudge or it effectively undermines the ruling!"

The standard answer to this accusation is that "linking something to an interest rate is not the same as actually charging or receiving interest". This is obviously true in academic terms but it doesn't convert many doubters. More convincing and comprehensive explanations are required to do that and we will consider a few of these key arguments next.

First and foremost, "Riba" as originally described, is not the same as modern day interest and it is a bit confusing to connect the two directly even though the latter is now banned under Islam as if they were. Secondly, there is no direct or accurate translation from ancient Arabic into English of the word "Riba", which adds to the uncertainty. The closest modern approximation is "Usury" or "an unwarranted, unreasonable or unearned premium, excess or surplus which is neither deserved nor fair".

As mentioned earlier, the prohibition of interest, especially usury, is not confined to Islam and has a long history spanning several traditions and civilisations including our own. Whilst everyone would accept that forbidding Usury is both correct and morally right, it is less clear to outsiders why Islamic Scholars have decided to ban interest completely given the crucial role it plays in Western economies. The simple answer is that an Islamic economy was and still is different.

### Quranic References

The Quran (Book of Allah SWT) refers to the term Riba several times but no definition is available and no detailed explanation is given in the practices of the Prophet (PBUH). Islamic Scholars don't know why, but they believe there are two likely reasons for this. Firstly, verses containing Riba were revealed towards the end of the Prophet's (PBUH) life and there may simply not have been enough time for the issue to be raised and explained. Secondly and perhaps more likely, the concept was so well known (like Usury is for us today), that no explanation was needed so everyone knew and agreed that Riba was wrong.

At the time of the Prophet's (PBUH) life, money was not regarded as a store of value and was not created to be hoarded for its own sake. This gives rise to one of the more powerful Islamic arguments against interest which explains more clearly the logic of the total ban.

If several people enter into a business venture together, then under Islamic rules, they must agree to share both profits and losses at the outset. Suppose each partner brings a different skill or input to the venture such as cash, labour, know how, or assets? It follows that each will request a share of the projected profits (and loss) based on the scarcity or demand for their particular contribution. In this way, everyone's return is agreed at the outset and is linked directly to the outcome of the venture.

If the venture fails, all will lose. If it succeeds, all will gain. No party can receive a minimum or guaranteed share even if the venture fails, yet this is precisely what would happen if the partner with the cash charged interest, or the partner with the know how wanted his pre-calculated profit share, regardless. In both cases the return demanded is deemed by Islamic Scholars to be unfair, excessive, unearned and unreasonable because it is not trade related and not actually earned.

The Quran explicitly prohibits Riba so anything that can be defined as Riba must be outlawed. The problem is, does this mean all interest or only some? There have many scholastic debates, including attempts to legitimize bank interest, but on balance and after what is now centuries of deliberations, the unanimous current



view is that all interest is Riba and is therefore is banned. In fairness it is hard to see, irrespective of the scholastic arguments, how partial prohibitions/exclusions could work equitably in practice.

The prohibition on charging interest does not preclude using interest rates as a reference point for calculating profit returns, as long as these returns are not linked solely or directly to interest rates themselves, as this would create uncertainty or Gharar as well as Riba, both of which are forbidden.

So there is no Islamic objection to a bank using interest rates as a reference point to calculate the required profit return as long as the amount is certain, the return is fixed, the project is trade related and the bank has a genuine stake in the outcome.

This takes us neatly back to the standard answer that “charging interest and using interest rates as a reference point is not the same”. It is indeed “not the same” and until a more reliable and independent mechanism for measuring returns and opportunity costs emerges, interest rates look set to retain their benchmark status.

So, if an Islamic bank cannot charge interest per se, but can use interest as a reference point on an opportunity cost basis, how does it structure its products to make a return? The answer is to provide a range of services that are genuinely profit (and loss) sharing and in which the bank’s required profit return or share is calculated using benchmark interest rates, is agreed with the client at the outset but actually depends on profit generation for payment.

There is a further complication in that to be Shariah compliant all lending activities have to be trade based, must involve real goods and services, must involve actual trade, avoid any uncertainty, avoid prohibited practices and must be carried out with the utmost integrity and good faith.

Applying these rules to an Islamic bank’s “lending” services has produced some complex sounding products but once these have been explored and understood it is relatively easy to identify a conventional bank equivalent.

We will cover only one in this article

and that is the Musharaka, sometimes know as Shirka which translates to “sharing” and is the Islamic form of partnership.

### **Musharaka**

Under a Musharaka one or more parties contribute to the financing and management of a Sharia compliant project agreeing to share profits and losses at the outset.

In the absence of an agreement profits and losses are shared in accordance with each partner’s capital contribution. Losses are always attributed in accordance with capital contributions so the biggest stakeholders stand to lose/gain the most, which is fair.

In a Musharaka arrangement, the Islamic Bank contributes funds to the partnership in return for an agreed profit share, usually calculated by reference to short or medium term interest rates depending on the length of the partnership. The bank can be either a permanent or diminishing partner and can take security either directly or from third parties.

A Musharaka project is akin to equity finance and is almost as close to ethical and pure trade related banking as it is possible to get. The genuine sharing of profits means the bank has a real stake in the outcome of its “clients” business and forces it to concern itself very closely with the management and completion of the scheme. The fact that the scheme must be Shariah compliant means it is genuinely wealth and trade enhancing and is concerned with beneficial activities only.

All well and good so far, except that very few banks are active in this market at present. Why?

The main problem is that as with equity finance, the due diligence process for a Musharaka is considerable as is the ongoing management and monitoring obligation. The costs of this direct involvement by the bank cannot usually

be rewarded adequately by the profit sharing arrangement neither can the very real risk of incurring losses be built in sufficiently. The net result is that whilst the Musharaka remains the shining example of Islamic ethics and principles, the hard truth is that it is not used that much in practice because it cannot be made to pay commercially in a modern banking environment. Other Islamic products require much less supervision, earn just as much for the bank and are therefore the preferred offerings.

**In Islamic Finance: An Introduction – Part 3 (Global Risk Update Q4 2009) we will cover these preferred “lending” products and will show how Riba influences their structure. We will also explain why the two main offerings, Murabaha (means “sale”) and Ijara (means roughly “lease”) are the two key offerings.**



# ISLAMIC FINANCE – AN INTRODUCTION – PART III

*Mark Andrews ACISI IFQ, is Risk Reward's Director of Islamic Banking and Finance. He has been an investment and retail banker for over 25 years and a qualified specialist in Islamic banking and finance. Since 2007 Mark has worked in most countries in the Gulf and Egypt advising on Islamic banking products and risk. In this third article in a series he considers how an Islamic Bank "advances" its funds, or in old fashioned banking terms, how it "makes its money".*

## INVESTMENTS

Whilst the terms "loan" or "lending" are commonly used, even by Islamic banks, they are not strictly correct in an Islamic context because an Islamic bank is engaged in mutual trading both with and alongside its clients on both sides of the balance sheet. An Islamic bank has a direct interest in the outcome of all these trading transactions, sharing both profits and losses with its partners/clients. Unlike a conventional bank where depositors are creditors and borrowers are debtors and there is almost no mutuality at all, an Islamic bank has partners, investors, principals and agents at every level.

**So an Islamic bank does not "lend", it "invests"!**

So how does an Islamic "invest" its funds? The answer is "very carefully" and for this reason only a handful of the Islamic products available are actually used in practice. This has caused Islamic banks – on the investment side at least – to become rather narrow specialists, dealing mainly in two products; split between Murabaha (akin to a loan) and Ijara

(akin to leasing operations). Most Islamic banks will advertise a wide range of Islamic investment products, including mortgage funding but most – in fact nearly all - have the lion's share of their investments in either Ijara or Murabaha form.

**Why is that?**

## THE COMMON QUESTIONS

Before answering the question and as a preliminary explanation, let us consider Islamic banking from the customer's viewpoint, as an investor (in our language, depositor) in an Islamic bank. During the author's informal discussions with Islamic banking staff, especially those dealing regularly with clients, three questions emerge that are nearly always asked by every prospective investor (depositor) in the bank.

The first is **"Promise me this is an Islamic Bank?"** This is a particularly common question when a "windows" or "branches" approach is being used by the bank but is also asked of wholly Islamic institutions. Some Islamic banks have





questioned the wisdom of operating “windows” as a result of this constant scrutiny and to be frank, there is something “other worldly” about entering a conventional bank and following signs for “Islamic banking, this way!” The second question is “**Is my money safe?**” which is interesting, given that for those of us banking with conventional banks, the prospect of an Islamic bank failing would mean we are probably all doomed! In nearly every Islamic jurisdiction either the State or the Regulator has made it clear that investors will not be allowed to lose their money and whilst nothing is impossible, it is hard to imagine an Islamic bank in the GCC in particular, being allowed to fail. The prospect of investors “sharing or bearing losses” as they agreed when they signed up (most don’t realise this by the way!), seems as remote as it can ever be.

The last question is “**Am I getting the best return?**” to which the answer is invariably “yes, of course”, because the answer “no, the bank down the road is more competitive than us!” might be career limiting!

Once these three common questions are satisfied, most clients, I am told, are then happy to take nearly everything else on trust. Is this any different from a conventional bank? Probably not in the case of the last two questions and it means that just like any financial institution, an Islamic bank’s cost of funds has to be set at a high enough level to attract new and retain existing investments. This obviously means that on the other side of the balance sheet the bank must make investments (loans) at a higher level of projected return than it pays for its source funds (deposits), to make a profit. So far, so good. But what is the easiest way in risk/reward terms to achieve this? Well, by using the simplest and most remunerative products which just so happen to be Murabaha and Ijara!

### MURABAHA – AN ANCIENT CONTRACT

Murabaha and Ijara are two of six ancient trading contracts, which predate Islam itself and are reckoned to be thousands of years old. Both have underpinned trading in the Middle and Far East for millennia and were adopted by the Prophet (PBUH) because they worked so well and still do.

Because Muslims may not charge interest but can make a profit, the basic trade deal, the Murabaha, is a “cost plus” transaction in which the seller supplies goods to the buyer at a price which includes his disclosed costs plus a disclosed profit. When accepting the goods, the buyer agrees to the selling price and is aware of how much profit is being made (the argument being he can choose not to buy if he dislikes the price). If the buyer requires time to pay, then this can be granted, usually in return for a higher price including a bigger profit. This is one of the ways that the time value of money can be covered under Islam without charging interest.

Before the reader cries “fiddle”, let us consider some of the Islamic rules surrounding Murabaha transactions which are designed to encourage fair trade. First the seller must own and possess the goods which must be under his control. The goods must have a fungible value and there must be no uncertainty about quantity, quality or delivery dates. The seller may not take advantage of the buyer, may not cheat, deliberately mislead, overcharge or be anything other than scrupulously honest with him or her. Delivery and transfer of ownership must take place when the transaction is concluded. Once the deal has been done, it cannot be amended without the express approval of both sides. There is also the usual

prohibition on trade in haram items (alcohol, guns, pork products etc.)

These ancient Murabaha trading rules are clearly framed to avoid disputes or problems and no doubt evolved over time. They were adopted by the Prophet (PBUH) because they worked so well. In fact a deal in which the seller has to be scrupulously honest and reveal both his cost price and his profit margin is remarkably refreshing to Western eyes where usually neither is disclosed.

### INTERNATIONAL DIFFERENCES

Provided the rules set out above are followed, a Murabaha can be for almost any amount and in theory any time period although the range is usually 6 months to 10 years depending on the bank which will also set minimum and maximum loan amounts.

So Islamic Banks provide Murabaha facilities for clients who want to purchase almost any item that qualifies. But there are some complications as a result of differing interpretations between Scholars which make the process slightly different even between banks based even in the same country. Take an example of a client wanting to purchase a car for US\$ 30,000 and being offered 100% funding on a Murabaha over a 4 year period.

For the transaction to be Islamic, the Islamic bank must be the owner and supplier of the car which means it must purchase and take delivery from the supplier before selling to its client. This creates a delivery risk as the client could walk away before the transaction is complete. Some banks insist on a promise to complete from their client, others go further and ask for a non refundable deposit (Arbun). Some Islamic Scholars are happy with either a promise or an Arbun or both, others are not saying it is not Islamic. (Luckily and at the risk of spoiling the story 99.99% of clients applying for funding do not walk away once the deal has been agreed!)

The second point of difference is delivery. Some Scholars insist the Islamic bank takes physical possession and in our example must store the vehicle in a warehouse prior to delivery. Others are happy for ownership to pass on paper, in other words there is constructive delivery only.

### RETURNS ON MURABAHA – USUALLY HIGH

Despite these differences, Murabaha s are priced at the higher end of the consumer funding scale and use as benchmarks the appropriate EIBOR, SIBOR or other medium/long term rate measurement. The risk/reward profile is at the better end of the scale for the bank, the transactions are simple (albeit document hungry), easy to establish, can be used for almost any purpose, are simple to manage and normally well secured. So from the Bank’s viewpoint this is relatively easy high coupon lending.

The only serious drawback is that the banks reward (profit margin ) must be fixed at the outset, when the Murabaha is agreed and delivery concluded, so the returns have to be set high enough to absorb rate movements against the bank. Either that or the portfolio must be turned over regularly so that the impact is diluted.

### NEXT ISSUE – PART 4

In the next article we will consider Commodity Murabaha – a controversial product in some areas, but not in others and Ijara.



# ISLAMIC FINANCE – CURRENT DEVELOPMENTS

*Mark Andrews ACISI IFQ, is Risk Reward 's Director of Islamic Banking and Finance. He has been an investment and retail banker for over 25 years and a qualified specialist in Islamic banking and finance. Since 2007 Mark has worked in most countries in the Gulf and Egypt and the Far East advising on Islamic banking products and risk. In this fourth article in a series, he considers some topical issues, looks at Murabaha in detail and explains why this is a staple product.*

In this fourth article we will look at some interesting current Islamic developments, we will continue to consider how an Islamic Bank “raises” its funds, or in old fashioned banking terms, where it “gets its money from”. We will look again at the Murabaha, which still accounts for the lion’s share of most Islamic banks “lending” or more correctly, investment activities – but will concentrate on Commodity Murabaha at one time a controversial product, now widely accepted.

## **Summary of Source of Islamic Bank Funds**

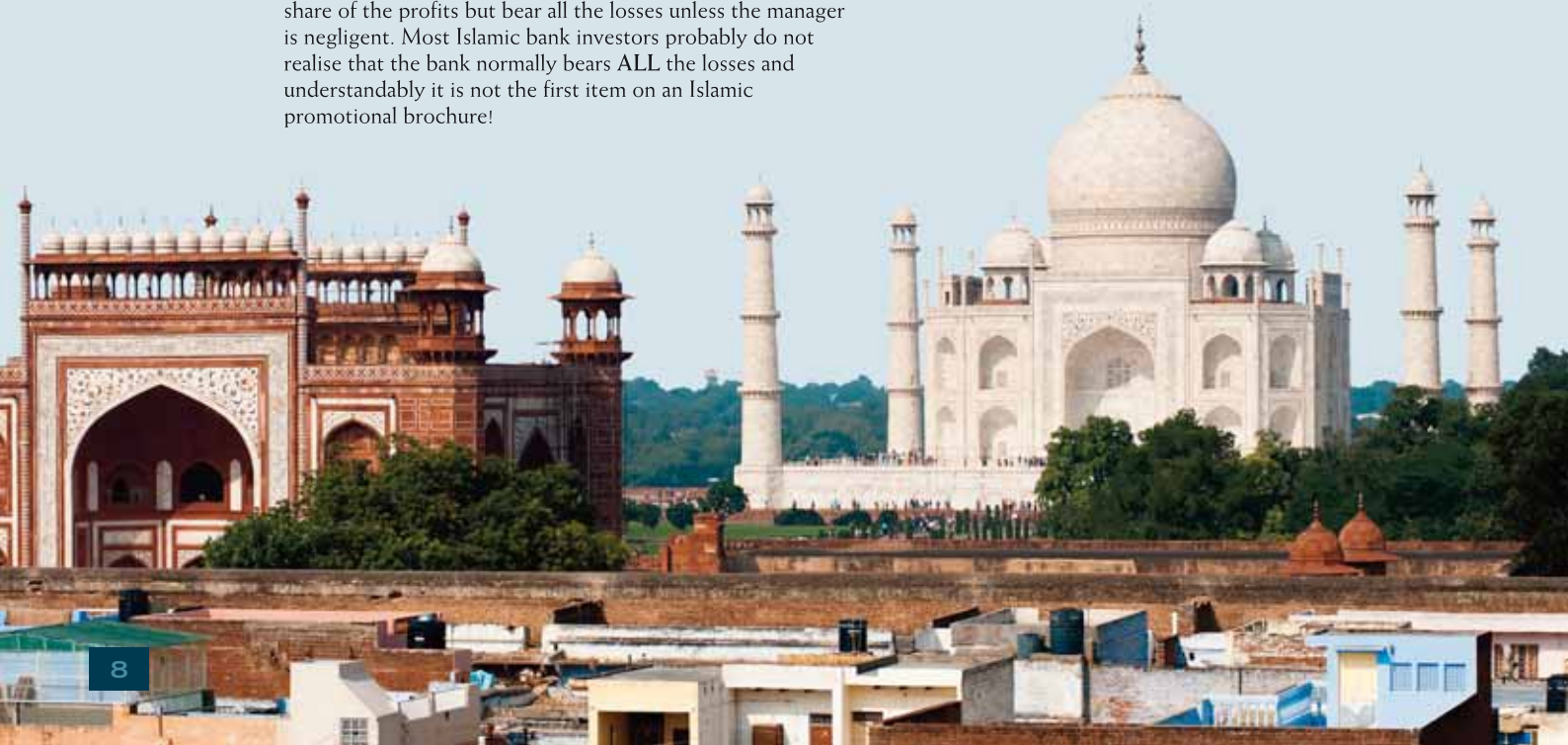
It might first be helpful to summarise the source of the Islamic Banks funds (their liabilities) which are all mainly short term and are usually a mixture of current accounts (*Amanah, Wakala and Wadia – Amanah is rare despite being the name of HSBC's impressive Islamic operation*) and deposit or term account equivalents, mainly Mudaraba with some Musharaka.

A Mudaraba is an investment for profit where the investors entrust their money to a professional manager, in this case the Islamic Bank. Under a Mudaraba the investors take an agreed share of the profits but bear all the losses unless the manager is negligent. Most Islamic bank investors probably do not realise that the bank normally bears ALL the losses and understandably it is not the first item on an Islamic promotional brochure!

## **Safety and Islamic Banks**

However, before you withdraw your money you need to recognise that Islamic banks have proved to be far safer and far more conservative than conventional banks because their activities are restricted, allowing them to build up impressive reserves, including profit equalisation reserves. Equalisation reserves are available to make up any shortfalls in indicative profit returns on Mudaraba investments, which to the writer’s knowledge, have never been negative or even nil. This is combined with the bank not taking high levels of risk and avoiding gearing.

In practice, it is almost inconceivable (but not impossible!) that an Islamic bank would make such huge losses that it had to pass these on entirely to investors in the form of negative returns and that it would actually do so. The reputational risk consequences are obvious and most commentators believe the regulatory bodies would step in long before this happened. Money invested in an Islamic bank in a stable country is probably as safe as an investment anywhere.





## ISLAMIC FINANCE – CURRENT DEVELOPMENTS CONTINUED

**Restricted v Unrestricted Mudaraba**

The interesting features of Mudaraba vehicles is that they are short term, usually repayable quickly or on demand and are unique to Islamic banks. Customers are neither depositors nor shareholders and the regulation of the products has challenged some authorities. This is because they can be “restricted” investment account holders (RIAH), or “unrestricted” (UIAH). A RIAH defines the range of Sharia compliant investments that can be acquired. This investment

Islamic players is a move towards the goal everyone wishes for but cannot yet see how to achieve. Namely a supreme Sharia “college” so the variations and contradictions in Fatwa rulings, even in the same country, can be either eliminated or better managed.

Insiders say the Fatwa contradictions make Islamic Banking “challenging & interesting”. To an outsider at the very least, it looks unhelpful.

**Islamic Bank outlooks**

The Dubai Islamic Bank, the oldest Islamic Bank established in 1975 recently disclosed that 8.7% of its assets (loans) are non-performing. This is an exceptionally high figure but is less surprising given its 35% shareholder, the Emirate of Dubai itself, will have expected the Bank to pioneer many of the prestigious and flagship developments in the Emirate, especially during the recent boom.

What an outsider cannot tell is how many loans are either in the “delay and re-issue” category or are “Zombie” loans – already dead but the bank dares not crystallise them yet.

First Gulf Bank on the other hand, the Abu Dhabi based Islamic bank, which has significant links with the

ruling Zayed family, continues to announce spectacularly impressive figures. First quarter returns for 2010 are up across the board and with only 2% of assets (loans) provisioned but not all considered lost.

**New Products**

To the astonishment of some, Dubai Islamic Bank (DIB), which has a reputation for being very strict in its Sharia Compliance where new products are concerned, has just launched a Salam product using salt to provide finance to personal individuals. Basically with some clever but Sharia compliant manoeuvring the client gets unencumbered money now in return for an agreed future liability using salt as the Shariah vehicle to accommodate this. More information is available on their web site.

Two consequences flow from this. Firstly other banks are surprised that the DIB Sharia board has agreed the product is Sharia compliant. Secondly, that DIB is targeting high ticket personal lending, presumably to replace property and construction where its books must be all but closed in practice if not publicly. Personal finance to HNW borrowers is not especially risk free.

**Murabaha – The Islah Product Briefing**

Dealt with in the last article but in summary it is a cost plus contract with all elements disclosed, Shariah compliant, with no uncertainty etc. A Murabaha can be for almost any amount and in theory any time period although the range is usually 6 months to 10 years depending on the bank which will also set minimum and maximum loan amounts.



by the bank on behalf the investors can be separated easily from other Bank funds and usually has a clear and definable audit trail

On the other hand, UIAH allow the bank to invest the funds as it sees fit in ANY Sharia compliant scheme so the risk profile is usually much higher and is not clearly defined. Worse still from a regulatory viewpoint, client's money is co-mingled with the Bank's own money and auditing or identifying the funds in a separate “bucket” is usually not possible. This is prohibited in many jurisdictions including Saudi Arabia.

However at the risk of labouring the point ANY investment in an Islamic bank is probably safer than in a conventional counterpart because they do not engage in such risky activities and as an industry have not made significant losses.

**Current Islamic Developments**

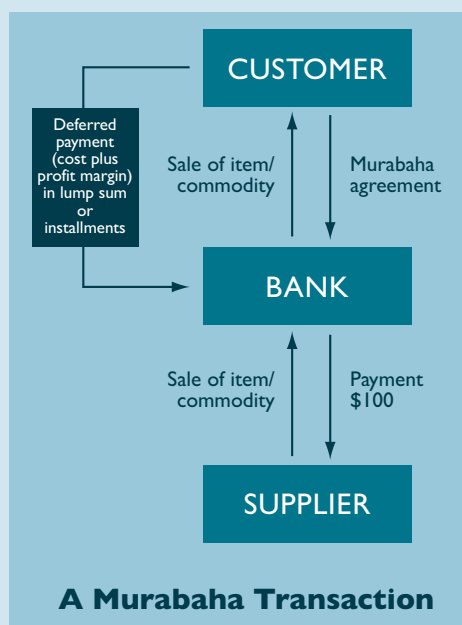
Dubai still hits the headlines with worries about the timing of the property recovery although perhaps the bottom of the markets has still not been reached. The market probably will recover eventually as Dubai has established itself successfully as a “playground” and does indeed potentially have a long term future. When, is the real issue, plus who can survive the necessary wait!

On the regulatory front, there is some encouraging evidence of a coming together between the GCC, dominated by Saudi Arabia and the Far East, especially Malaysia with several recent high level meetings taking place. The almost universal adoption of the IFSB (a Malaysian initiative) by the leading

## ISLAMIC FINANCE – CURRENT DEVELOPMENTS CONTINUED

The attraction for Islamic Banks who provide Murabaha facilities is the returns are high, it is a relatively simple product to market and sell and the risk profile is low. The main drawback is rates are fixed at the outset and the average term is 5 years. This creates an immediate mismatch with funding sources (nearly all short term) and leaves the bank vulnerable to increases in the cost of funds (interest rates). A large portfolio of well spread and maturing Murabaha protects partially against interest rate fluctuations as new, higher return products replace maturing lower return deals, but not completely. In addition a Murabaha cannot be turned quickly into cash in a crisis.

To remind ourselves how a Murabaha works:



### Tawarruq

Means to "monetise" and is also called "Commodity", "Reverse" or "Two Tier" Murabaha although each has a slightly different construction in different jurisdictions.

In most cases two separate Murabaha contracts are used to create cash and a loan liability.

In simple terms, imagine you bought a car on a Murabaha for \$20,000 from a bank on one year terms. The bank would complete the deal by creating a "loan" or Murabaha liability of say \$22,000, if the rate of the return (profit) required by the bank is 10%.

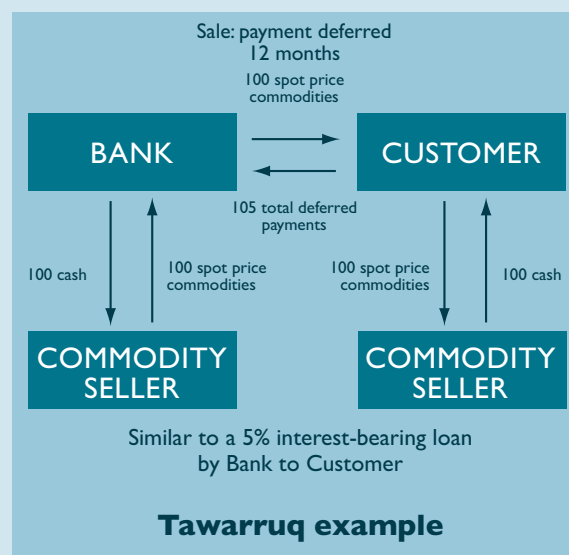
At this point you have the vehicle and a \$22,000 loan. All very normal.

Imagine you simultaneously sold the car to another dealer for \$20,000 or something very close as it is a still brand new and unused, using a Murabaha contract with payment on delivery.

You now have \$20,000 cash and a 1 year liability of \$22,000 (the loan amount). By using two separate Shariah compliant contracts you have created a cash loan.

When they were first introduced, these transactions met with strong resistance in some quarters with scholars condemning them. The grounds are it is Riba, no real trade taking place, no intention to take delivery or ownership of the goods and nothing beneficial to the community has occurred. The objections were even stronger if the buyer and seller of the goods was the same party – especially if it was the Islamic Bank.

This is how it works:



This form of funding has become a vital component of short term investment operations by Islamic Banks using permitted commodities (Gold and Silver forbidden as they were once "money"), to invest or acquire funds in a similar fashion to conventional inter-bank markets.

Sharia objections are beginning to fall away as the practice becomes established and many scholars approve them on the basis that some trading benefit accrues and as long as there are two separate parties on the buy and sell side. However, not all banks agree.

### Next Article

In the next article, as well as debating topical Islamic issues, we will consider Ijara and the ways banks avoid being locked in to long term fixed rentals by using a two contract system.



# IFQ

## ISLAMIC FINANCE QUALIFICATION AND TRAINING COURSE

The IFQ is a ground-breaking qualification that covers Islamic finance from both a technical and a sharia perspective, providing the first international benchmark in the area of Islamic finance.

It provides delegates with an understanding of the influence of sharia in a business context and prepares delegates to hold key positions in the Islamic finance and takaful (Islamic insurance) industries.

The qualification and training course are appropriate for existing and new employees and those seeking a career in Islamic finance. Since its launch, the exam has been taken in over 40 countries.

“Since its inception the IFQ has been highly acclaimed as it contributes to the widening and deepening of the skills of financial practitioners. We are confident that this third edition will further confirm its pertinence to the financial industry at large.”

Raed H. Charafeddine  
First Vice-Governor, Banque du Liban  
Chairman, Advisory Council for Islamic Finance

### Key Features of the IFQ

- ✓ Provides an essential knowledge of the general principles of sharia (fiqh al muamalat) and its application to Islamic banking and finance.
- ✓ Covers the different types of Islamic finance contracts and products available.
- ✓ Examines the practices used in the Islamic financial markets and the principles behind investment selections.
- ✓ Employing IFQ holders indicates that a company is contributing to the development and promotion of high ethical standards amongst its staff.
- ✓ Initiated and supported by the Central Bank of Lebanon (Banque du Liban).
- ✓ Awarded jointly by the Chartered Institute for Securities and Investments (recognised by Ofqual, the UK government education regulator) and l'Ecole Supérieure des Affaires (ESA).
- ✓ Available internationally.

### Who Should Attend?

All banking and finance professionals either working within an Islamic financial institution or intending to do so and any other professionals working in the field who wish to develop their skills and understanding of Islamic finance.



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### Endorsed by the Financial Services Skills Council (FSSC)

The IFQ features on the FSSC Recommended List of Examinations. The FSSC is an employer-led body with a remit to provide advice and guidance to employers in the financial services sector on suitable qualifications for their staff.

### Advisory Council for Islamic Finance

The IFQ was initiated by the Central Bank of Lebanon (Banque du Liban) and was jointly created by L'Ecole Supérieure des Affaires (ESA)  **Ecole Supérieure des Affaires** and the Chartered Institute for Securities and Investments (CISI). These bodies convened the Advisory Council for Islamic Finance (ACIF), a group of experts to develop the qualification.

The ACIF oversees the IFQ. The ACIF chairman is Raed H. Charafeddine, First Vice-Governor, Banque du Liban.

### Assessment Structure

- The IFQ is a two-hour, 100 multiple-choice question exam.
- The pass mark is 70%.
- Preparation, using the accompanying workbook, requires approximately 100 hours of personal study time.

### CISI Membership

Individuals who successfully complete the IFQ are eligible to become Associate Members (ASI) of the Institute. For further details visit [www.cisi.org](http://www.cisi.org)

**"I would strongly recommend this qualification to staff working and seeking to work in the Islamic finance industry. This prestigious, global qualification offers essential knowledge of the general principles of sharia with respect to its application to Islamic banking and finance. The IFQ is a key qualification in this growing market."**

**Sultan Choudhury, Commercial Director  
Islamic Bank of Britain**



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The nature of Islamic current accounts; the nature of the major contracts – mudaraba, musharaka, murabaha, ijara, salam, istisna; the use of letters of credit and guarantees in Islamic finance contracts.

#### Session 5: Financial Statements for Islamic Banks

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#### Session 6: Islamic Corporate Governance

The different approaches to corporate governance; additional challenges presented by Islamic banks; the role of the sharia supervisory board and corporate governance issues in takaful.

#### Session 7: Islamic Asset and Fund Management

The purpose of investment in Islam; prohibited industries; replicating conventional deposit structures using murabaha and mudaraba; investment funds using Ijara; the Islamic stock selection process and the role of the sharia supervisory board.

#### Session 8: Islamic Bond Market - Sukuk

The nature of sukuk compared with conventional bonds; issuing sukuk; different types of sukuk; AAOIFI standards for sukuk and rating sukuk issues.

#### Session 9: Islamic Insurance - Takaful

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